INDEX

CITATIONS

In the Supreme Court of the United States

October Term, 1926

No. 289

The United States, petitioner
v.
Charles A. Ludey

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

BRIEF FOR THE UNITED STATES

OPINION OF THE COURT BELOW

The opinion of the Court of Claims is found on Pages 14 to 20, inclusive, of the transcript. It is reported in 61 C. Cls. 126.

GROUNDS OF JURISDICTION

The judgment to be reviewed was entered by the Court of Claims on November 9, 1925. (R. 10). A petition for certiorari was filed February 4, 1926 (R. 20). It was granted by this Court April 19, 1926 (271 U. S. 651), under Section 3 (b) of the Act of February 13, 1925 (c. 229, 43 Stat. 936, 939).

THE QUESTIONS INVOLVED

This case presents three distinct questions:

1. In determining the amount of gain or loss resulting from the sale of an oil producing property, should the previous exhaustion occasioned by the extraction and sale of oil (depletion), as well as the original cost of the property, be taken into account?

2. In determining the amount of gain or loss resulting from a sale of physical assets, such as buildings and machinery, should the previous exhaustion, wear and tear occasioned by the use of such assets (depreciation), as well as the original cost, be taken into account?

3. In determining gain or loss, should a taxpayer be allowed to deduct as a part of the cost of property sold the amount which had previously been returned to him by way of an allowance for the exhaustion, wear and tear of the properties (depletion and depreciation)?

STATUTES INVOLVED

The Revenue Act of 1916 (Title I, Act of September 8, 1916, c. 463, 39 Stat. 756, 757–759), as amended by the Revenue Act of 1917 (Act of October 3, 1917, c. 63, 40 Stat. 300, 329), provides in part as follows:

> Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or

compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

*   *   *   *   *

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

Sec. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

*   *   *   *   *

Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: *Provided,* That for the purpose of ascertaining the loss sustained from

> the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;
>
> Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom * * *.

STATEMENT OF THE CASE

This suit was instituted in the Court of Claims to recover the sum of $11,715.45 with interest, Federal income and excess profits taxes alleged to have been illegally assessed and collected for the year 1917, after a claim for the refund of such taxes had been filed by the taxpayer and denied by the Commissioner. (R. 5 to 7.)

The findings of the Court of Claims show that respondent, Charles A. Ludey, filed a return of his income for the calendar year 1917. (R. 11.) In this return he claimed as a deduction from gross income an alleged loss of $7,621.33 said to arise from the sale in 1917 of certain oil properties, some of which were acquired before and some after March 1, 1913. (R. 11, 12.)

The respondent contended in his petition in the court below that the loss was $14,777.33, which is more than that claimed in his return. (R. 6.)

The Commissioner of Internal Revenue found that respondent derived a taxable profit of $26,904.15 on such sale. (R. 14.) The Court of Claims found that there was a deductible loss of $7,927.33. (R. 12.)

The properties sold ~~as~~ are designated (R. 5, 6) as (1) The Goodman Farm; (2) The Matney Farm; (3) The Wolfe Farm; (4) The Billingslea Farm; (5) The Pitney Farm; and (6) a one-third interest in the Helphrey Oil Drilling Rig. These properties were acquired as follows:

In 1911 the respondent purchased the Goodman Farm in fee and a lease to the Matney Farm, together with the physical equipment thereon, at an aggregate price of $20,000. On March 1, 1913 the fair market value of the oil reserves on these farms was $39,500, and the fair market value of the physical equipment was $8,000, making a total fair market value of the oil reserves and equipment of $47,500. (R. 11.) In July, 1913, the respondent purchased a lease to the Wolfe Farm and paid for the oil reserves thereon $17,500 and for the physical equipment thereon $9,000, a total of $26,500. (R. 11.) In December, 1913, the respondent purchased a lease to the Billingslea Farm and paid for the oil reserves thereon $5,000 and for the physical equipment thereon $6,000, a total of $11,000. (R. 11.) In February, 1915, the respondent purchased the Pitman Farm in fee for $3,000.

After March 1, 1913, the respondent added to the Goodman Farm equipment and improvements at a

cost of $6,000 and equipment and improvements to the Wolfe Farm at a cost of $1,794. (R. 11.)

Between March 1, 1913, and February, 1917, when the properties were sold, the respondents operated them and extracted from the oil reserves certain quantities of oil which depleted the oil reserves in the sum of $32,253.81. (R. 12, Finding V.) The depletion thus sustained was not, in full, an allowable deduction from the respondent's gross income for the respective years in which it was sustained under the Revenue Acts then in force. For the years 1913, 1914, and 1915 the allowable deduction was, under the Revenue Act of 1913, five per centum of the market value of the output for the year for which the computation was made. (Revenue Act of 1913, Section II B, c. 16, 38 Stat. 114, 167; Regulations 33, Articles 141, 142, T. D. 1944, promulgated January 5, 1914; see Appendix hereto.) For the year 1916 and that portion of the year 1917 preceding the sale the respondent was entitled to deduct depletion sustained. (Revenue Act of 1916, Title I, Part I, Section 5 (a), Paragraphs Seventh and Eighth; Part II, Section 12 (a) "Second," c. 463, 39 Stat. 756, 759, 768; see Appendix hereto.) The amount of depletion allowable under the Acts from 1913 to 1917 is not shown by the Record.

Between March 1, 1913, and the date of sale in February, 1917, the physical equipment and improvements on the properties were depreciated in

the sum of $10,465.16. (R. 12.) During the years 1913, 1914, 1915, 1916, and 1917 the taxpayer was entitled under the Revenue Acts in force during the respective years to deduct from his gross income the depreciation actually sustained. (Revenue Act of 1913, Section II B (6), 38 Stat. 114, 167; Revenue Act of 1916, Title I, Part I, Section 5 (a) "Seventh," 39 Stat. 756.)

During the years in question the respondent deducted and was allowed as depletion and depreciation from his gross income on his tax return for the respective years an aggregate sum of $5,156. (R. 12.) This was less than one-half of the depreciation alone which he was entitled to deduct. The taxpayer's reason for not claiming in full the deductions to which he was entitled in the respective years for which he was entitled to them is not shown by the record. There is no finding showing to which of the properties the depreciation and depletion actually deducted and allowed applies. Nor is there any finding showing the depletion or depreciation sustained with respect to each of the properties. Such findings were not necessary to the decision of the case on the theory adopted by the Court of Claims, but are necessary if the correct theory is that the sales were separate and account should be taken of depreciation and depletion.

The taxpayer sold all of the properties in February, 1917, for a price which in the aggregate is

$81,200, and which the Court of Claims allocates to the respective properties as follows (R. 11, 12):

To the Pitman Fee	$4,500
To the Goodman Fee and Matney lease with equipment and improvements thereon	46,650
To the Wolfe lease and Billingslea lease and their equipment	29,850
To the one-third interest in the Helphrey oil-drilling rig	200

The price obtained for the Goodman fee, the Matney lease, the Wolfe lease, and the Billingslea lease was allocated on the basis of the daily production of the four properties, which is the basis on which they were sold. (R. 12.)

In determining whether or not there was a gain or loss derived from the transaction the Commissioner of Internal Revenue held that since the oil reserves bought had been decreased by reason of the extraction therefrom of a certain amount of oil the cost (or March 1, 1913, value) of which was represented in dollars and cents by $32,253.81, and that since the equipment and improvements had been changed in character by wear and tear, which change was represented in dollars and cents by $10,465.16, the cost (or March 1, 1913, value) should be decreased so as to exclude from the cost of the property sold the cost of that portion of the property which had prior to the sale been extracted or used up. He, therefore, deducted from the cost price the amount of depletion sustained, namely, $32,253.81, and the amount of depreciation sustained, namely, $10,465.16. The difference between the cost (or March 1, 1913, value) thus decreased

and the selling price obtained showed a gain which the Commissioner included in the taxpayer's taxable income. (R. 12.) On the other hand the respondent in arriving at the loss which he now claims should be deducted from his gross income as having been sustained from this transaction does not take into account the decrease of the oil reserves or the wear and tear of the equipment, and, therefore, does not deduct anything for depletion or for depreciation from the cost (or March 1, 1913, value). (R. 8.)

The computations of the Government and of the taxpayer are as follows:

	Commissioner's calculation	Taxpayer's calculation
March 1, 1913, value Goodman fee and Matney lease	$47,500.00	$47,500.00
Cost of equipment added after March 1, 1913	6,000.00	6,000.00
Cost of Wolfe lease	26,500.00	26,500.00
Cost of equipment added	1,794.00	1,794.00
Cost of Billingslea lease	11,000.00	11,000.00
Cost of Pitman fee	3,000.00	3,000.00
Cost of Helphrey oil rig	183.33	183.33
Total, value and cost	95,977.33	95,977.33
Less:		
Depletion for oil extracted by taxpayer	32,253.81	000.00
Depreciation on equipment through use	10,465.16	000.00
	42,718.97	000.00
Cost (or value of remaining property at date of sale in 1917)	53,258.36	95,977.33
Selling price in 1917	81,200.00	81,200.00
Gain	27,941.64	00,000.00
Loss	00,000.00	14,777.33

The Court of Claims does not adopt either computation, but considers the transaction as consisting of separate sales of the properties and deter-

mines the gain or loss with respect to each sale without making any adjustment for the depletion or depreciation of the property sold, and thus determines that there is a loss of $7,927.33. (R. 12.)

SPECIFICATION OF ERRORS

The Court of Claims erred in granting judgment for the respondent and in holding that in determining the gain or loss resulting from the sale of the properties involved in this case depletion and depreciation, either sustained or allowed in previous years, should be disregarded.

SUMMARY OF THE ARGUMENT

The sale of the capital assets herein did not result in an actual loss deductible from gross income for the purpose of determining net income under the provisions of the Revenue Act of 1916, as amended. The statute provides for the deduction of *actual* losses sustained. When the transaction involved in this case is considered as a whole, it is apparent that there was no actual loss.

A taxable gain resulted from a sale of capital assets owned by the taxpayer. The increment in the value of property during ownership, when realized by sale, is taxable gain. The amount of such increment can not be determined except by adjusting the cost of the property with reference to physical changes which occurred during ownership. There were physical changes in the property involved in this case, for the property is not to be

considered for tax purposes as mere legal rights, but is to be considered, as in fact it is, as oil, machinery, buildings, etc.

The physical changes thus occurring are measured by depletion and depreciation sustained. The purpose of deducting the amount of depletion, exhaustion, wear and tear sustained from the *cost price* is to fix the extent of the physical changes in the property, which is entirely distinct from the question whether the statute permits similar deductions from *gross income* for the purpose of determining taxable income.

Even if the amount of depletion, exhaustion, wear and tear sustained is not the proper index of the physical change, the amount of depletion and depreciation for which the statutes allow as deduction from gross income should be deducted from the cost, even if such allowances are not taken by the taxpayer. The statute having provided the method by which and the time when the taxpayer shall be entitled to a restoration of his capital investment, the taxpayer can not elect a different time or method.

In any event, in so far as capital has in fact been restored by previous allowances, adjustment of cost must be made unless it is held that the statute contemplates two deductions for the same item.

ARGUMENT

I

The Transaction Did Not Result in an Actual Loss, Whether any Adjustment of the Basis for Determining Gain or Loss Be Made or Not

It seems clear that the transaction here involved, originating in the purchase, continuing through the operation, and ending in the sale, did not result in an *actual* loss deductible from gross income for the purpose of determining net income under the provisions of the Revenue Act of 1916 as amended.

That statute permits the deduction of "losses actually sustained during the year, incurred in his business or trade * * *." (*McCaughn* v. *Ludington*, 268 U. S. 106; *United States* v. *Flannery*, 268 U. S. 98.)

On March 1, 1913, the taxpayer had a capital asset worth $47,500.00. Thereafter he acquired certain other properties and made certain improvements at a total cost of $48,477.33. During the period of his ownership, the taxpayer reduced to his possession and ownership oil which at the well (Art. 142, Reg. 33, T. D. 1944, Appendix) represented a cost to him of $32,253.81. (R. 12, Finding V.) In 1917, he sold what was left of the original properties for $81,200.00. The total receipts, therefore, were: oil appropriated, $32,253.81; property sold, $81,200.00; total, $113,453.81. His capital investment was $95,977.33. The result of the whole transaction

was a gain. The transaction, therefore, did not result in any *actual* loss to the taxpayer. (*Bowers v. Kerbaugh-Empire Company,* 271 U. S. 170.) To demonstrate this, it is only necessary to assume that instead of extracting a part of the available oil the taxpayer had extracted all of it, and had then sold the properties for a nominal sum. Under such circumstances, it could hardly be contended that the taxpayer has a deductible loss when in fact he has made a profit. The unreasonableness of such a contention may be illustrated by the case of a man buying a valuable lease in 1914 for $10,000; extracting and selling at a cost of $5,000 all the oil, for which $25,000 is received; then selling the lease for $5.00; and taking as a deduction against the profit from the sale of the oil the difference between the cost of the lease and the price obtained for it.

II

The Basis for Determining Gain or Loss is the Cost or March 1, 1913, Value, as the Case May Be, of the Property Sold, but this Basis Must Be Adjusted with Reference to Depletion and Depreciation

1. Introduction.

There are four theories upon which the gain or loss realized upon the sale of capital assets, which during ownership have been depreciated or depleted, can be calculated.

The first theory and that which the Government contends is correct is that the amount of depletion

or depreciation, as the case may be, which has actually been sustained by extraction and sale of oil and wear and tear on equipment shall be deducted from the cost price as representing the physical change in the character of the property during ownership to the end that the price obtained for the property at the time of sale may be compared with the cost of like property.

Adopted

The second theory is that depletion or depreciation should be deducted from the cost only to the extent that the statutes in force during the years of ownership permit such depreciation or depletion to be deducted from gross income, and this whether or not the taxpayer in fact availed himself of the privilege extended him by the statute of taking such deductions.

The third theory is that the amount of depletion or depreciation which has actually been charged against gross income in prior years should be deducted from the cost.

The fourth theory is that adopted by the Court of Claims, upon which theory there is no deduction from cost for either depreciation or depletion, whether sustained, allowable under the statutes, or actually allowed in the particular case.

In regard to depreciation, it will be noticed that there is no difference between the first and second theories mentioned above for the reason that all depreciation sustained is and has always been an allowable deduction in computing gross income. In

regard to depletion, the first and second theories to some extent overlap for the statute in effect during the years 1913, 1914, and 1915, while permitting a deduction for depletion limited the deduction so that in certain cases it might not equal the depletion actually sustained. However, as to depletion sustained after January 1, 1916, the first and second theories are identical, inasmuch as after that date all depletion sustained was actually allowable.

2. In determining whether there is a gain or loss from the sale of a capital asset, the basis, cost or March 1, 1913 value, as the case may be, should be reduced by the amount of depletion or depreciation sustained.

Both depletion and depreciation change the character of property. In some cases the change is so great as, manifestly, to make it unreasonable to say that the property bought is the same thing as the property sold, e. g., a lot with a new house on it bought and sold after the house has been demolished by time and use. In other cases the change is less apparent because the property has the same name before as after depletion and depreciation have been sustained, e. g., an oil lease. But in both cases the change takes place and must be recognized as having taken place when it comes to a determination of a gain or loss realized by the sale of the changed property because gain or loss is the difference between the cost (or value) of the exact property sold and the price for which it is sold.

(*a*) *The character of an oil property is changed by the extraction of oil from the reserve.*

In the operation of an oil property, the whole gain is derived from the removal and sale of oil and the increment in the value of the oil remaining in the ground and in the right to remove it. This increment depends upon factors collateral to the right, among others, the demand for oil. As this demand increases, the value of the right increases. Consequently, when it becomes necessary to ascertain whether or not a gain has been derived from the sale of an oil property, it is necessary to ascertain what, if any, increment in value has accrued to the property sold and is included in the sale price. This increment is reflected in the price per barrel of daily production, upon which basis developed oil properties are usually bought and sold and upon which basis the properties involved in this case were in fact bought and sold. (Finding IV, R. 12.) For example, if a well producing ten barrels per day is bought in 1913, its price might be $10,000.00, which is another way of saying that that property is expected to produce ten barrels of oil per day for one thousand days, if oil is worth "in the ground" one dollar per barrel. If this property later is sold at $1,500.00 per barrel of daily production, and the daily production is nine barrels, then it is manifest that, since the expected productive life is shorter, the value per barrel "in the ground" has increased. This

increase is realized when the right to remove and sell the oil is sold, and the gain attributable to the sale of the oil reserves in this case is a realization of such increment in the value in the ground of unextracted oil because the findings do not show any new development. Manifestly this increase in the value of the unextracted oil cannot be ascertained by comparing the total cost of the oil reserve as it existed at the time of purchase with the price obtained for that part of it remaining at the time of sale.

The cost or value of the property is merely the *basis* for determining gain or loss. Further steps are necessary in such determination, one of which is the comparison of the *property sold* with the property bought. These properties must be identical, for it is the cost (or value) of the property sold which is the basis for determining the gain derived from the sale. If, after the property is acquired, its character has for any reason been changed, then, while it may be possible that the taxpayer is entitled to a deduction from income by reason of such change he is not entitled to compare the cost of the unchanged property with the selling price of the changed property for the purpose of determining whether a gain has been made. The distinction is this: If the taxpayer had, without removing any oil, sold his right for a less sum than it cost him, he would have sustained a loss because the decrease in value would have been due to economic causes, such,

for instance, as an error in the estimate of the oil reserve at the time the taxpayer acquired it, or a decrease in the value of the oil in the ground. But to the extent that the decrease in value is due to the removal of oil, it is not due to economic causes, but to changes in the nature of the property acquired which occur after such acquision but prior to the sale of the property.

The Court of Claims holds that the respondent sold exactly the same property which he bought, namely, the right to remove oil and that, since the oil recovered during his ownership was income and not a return of capital, no deduction from cost price should be made for the purpose of ascertaining gain. Assuming that the right is the substance of the purchase, although in truth it is merely the shadow, the Government urges that the taxpayer has *not* sold even the right which he acquired. This is necessarily true because in the meantime the taxpayer has used that right and converted a part of the oil to his own use. Whether or not this conversion produced income is immaterial and it is likewise immaterial that the taxpayer has not deducted or been permitted to deduct the cost of property previously sold. The material factor is that the conversion reduced the oil reserve, and thus changed the character of the property. Although this change is expressed in dollars and cents for accounting purposes, it really means that a certain number of barrels of oil have been taken from

the reserve. It signifies a change in the extent of the property. Not only is the value of the property decreased but also the extraction of oil destroys a part of the property which the taxpayer acquired when he purchased. Although oil is a fugitive, the right to take *all* is necessarily affected by taking some. The interest of the taxpayer was lessened by the removal of oil. *Lynch* v. *Alworth-Stephens Company,* 267 U. S. 364.

The Court of Claims answers this contention by pointing out that the respondent did not purchase a certain number of barrels of oil stored in the earth. The Court states "he purchased a mere right to explore and bring to the surface and into his possession whatever oil he could find." (R. 15, 16.) Theoretically, that statement is correct, but as a practical matter, the right which was purchased was an *oil reserve* which was susceptible of approximate measurement. The price which the respondent paid was based upon the number of barrels estimated to be in the reserve. Disregarding any supposed legal theory, the respondent in fact purchased an oil reserve of so many barrels. (R. 11, Finding IV.) Likewise, when he sold, the price he received was based upon the number of barrels estimated to be in the reserve at the time of the sale. It is quite inaccurate, as a practical matter, to say that the right which the respondent sold was the same as the right which he purchased. It is true that after the removal of part of the oil he had his leases and his fee. But he did not have the

oil reserve, so when he sold, he did not sell that which he bought.

(*b*) *The character of buildings, machinery, and equipment is changed by wear, tear, and exhaustion.*

The Court of Claims makes no adjustment for the depreciation of buildings, machinery, and equipment because, it says, the depreciation "was covered in the sale price." (R. 16.) By this it is understood that the court means that the property sold brought less money because of its depreciated condition. One of the factors which entered into the sale price was the depreciated condition of the property. Another factor was the increment in the value of the property. This factor the court ignores. The vice of the court's ruling results from its comparing the cost of a new property, which does not "cover depreciation," with the selling price of a depreciated property. In other words, the fact that the taxpayer in this case sold a depreciated property for less than he paid for a different property furnishes no reasonable basis for making any calculation. The value of the property new, as it was at the time it was acquired, should not be deducted from the value of the property in its condition when sold to determine gain or loss, because, while the depreciation was "covered in the sale price," it was not "covered in the cost."

Buildings, machinery, and equipment are consumed in the use so that it is impossible for one to retain such property for a period of time and then

sell that which he acquired. He buys new property and sells depreciated property. This depreciation is a loss suffered during ownership, and a loss for which the income tax statutes make due allowance. It can not be offset against increment in value (*LaBelle Iron Works* v. *United States,* 256 U. S. 377), and the gain from a sale is the realization of appreciation ~~apprication~~ in value. It represents the increase in value of the depreciated property during ownership. This principle has consistently guided the Bureau of Internal Revenue in computing gain or loss from sale. It has been sustained directly by the Board of Tax Appeals in *Appeal of Even Realty Company,* 1 B. T. A. 355, and by inference by the courts in *Philip Henrici Company* v. *Reinecke,* 3 F. (2d) 34, and *Kaufman-Straus Company* v. *Lucas,* 12 F. (2d) 774.

3. IF THE BASIS SHOULD NOT BE REDUCED BY DEPLETION AND DEPRECIATION SUSTAINED, IT SHOULD AT LEAST BE REDUCED BY DEPLETION AND DEPRECIATION ALLOWED BY THE STATUTES AS A DEDUCTION FROM GROSS INCOME.

The reason that the cost, or March 1, 1913, value is deducted from the sales price in determining gain or loss is to restore to the taxpayer his capital investment tax free.

Goodrich v. *Edwards,* 255 U. S. 527, 534.
Doyle v. *Mitchell Bros. Co.,* 247 U. S. 179.

This does not require that all the cost (or value) must be returned before there is any gain. Thus in the *Mitchell Bros. Co. case* the entire value of

all the stumpage which the taxpayer owned was not deducted, but only the value of that part which was cut and converted during the taxable year. The requirement is that the taxpayer's capital shall be kept intact.

The purpose of the rule is satisfied if the taxpayer's capital is returned to him tax free either by way of a deduction from the gross receipts from sales or by way of a deduction from gross income. (*Doyle* v. *Mitchell Bros. Co., supra.*)

Congress has adopted the latter method, and, indeed, it is more equitable and just that the taxpayer should be allowed to replace his capital as it is expended than to require him to wait until the capital asset has entirely disappeared before any recoupment is allowed. The taxpayer is, therefore, permitted to replace his capital out of his income. To the extent that the taxpayer is thus entitled to recover his capital tax free the cost of his capital asset is reduced, and there is no capital investment to be restored when the asset is sold. To hold otherwise is to permit the taxpayer to increase his capital investment without paying any tax on the increase.

The taxpayer in this case under the applicable Act was entitled to recover $10,465.16 of his capital investment by way of depreciation allowances in 1913, 1914, 1915, 1916, and 1917. During the same period he was entitled to recover some part of $32,-253.81 by way of depletion allowances. For some reason he did not claim such deductions in those

years. He does not now seek to do so. But he here says that because he did not take advantage of the right given him by statute he can recover his total capital investment from the income of a later year. Further, he delegates to himself the right to choose the year in which he shall have the benefit. In other words, he claims that he is entitled to recoup from taxable income in the year 1917 a loss, which, had he availed himself of his statutory rights, would not have been suffered.

4. THE EFFECT OF THE DECISION OF THE COURT OF CLAIMS IS TO PERMIT A DEDUCTION FROM THE SALE PRICE OF AN AMOUNT PREVIOUSLY DEDUCTED, BY WAY OF DEPRECIATION AND DEPLETION, FROM CAPITAL INVESTMENT IN PRIOR YEARS.

Even if the decision of the Court of Claims is sound in regard to depletion and depreciation sustained or allowable but not allowed as a deduction in previous years, it would seem quite apparent that the cost of the properties should be reduced to the extent that depletion and depreciation were actually allowed and deducted by the taxpayer in his previous returns. His capital has, in fact, been restored tax-free by such allowances and the statute does not contemplate such a double deduction. *Nashville, C. & St. L. Ry. Co.* v. *United States*, 269 Fed. 351 (certiorari denied 255 U. S. 569). To the extent that the depreciation and depletion have been allowed and deducted in prior years, the result of the decision of the Court of Claims is that

the taxpayer, having deducted a part of the capital investment by way of depreciation and depletion allowances in prior years, is permitted to deduct it again from the sales price and thus show a loss which never occurred. The findings of fact (R. 12, Finding V) show that depletion and depreciation were deducted in the amount of $5,156.00 (R. 12). The findings do not show to what property it applied, so that the loss or gain on the sales, on this theory, can not be determined.

As the properties were all sold in 1917, some of them together, the Commissioner did not attempt to make a separate computation for each property, but the Court of Claims did. Its method is open under the findings, since they provide information for allocating the selling price to the various properties (R. 12). The United States takes no exception to this method of treatment in this case.

CONCLUSION

The judgment of the Court of Claims should be reversed.

Respectfully submitted.

WILLIAM D. MITCHELL,
Solicitor General.

A. W. GREGG,
General Counsel,
Bureau of Internal Revenue.

T. L. LEWIS, JR.,
Special Attorney,
Bureau of Internal Revenue.

APRIL, 1927.

Appendix

Section II, B, of the Tariff Act of October 3, 1913, c. 16, 38 Stat. 114, 167, is, in part, as follows:

> That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid within the year by a taxable person on indebtedness; third, all national, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits; fourth, losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise; fifth, debts due to the taxpayer actually ascertained to be worthless and charged off within the year; sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made: * * *.

Articles 141 and 142 of Regulations 33, promulgated January 5, 1914, by T. D. 1944, construing

the provisions of the Revenue Act of 1913, read as follows:

> ART. 141. The depreciation of coal, iron, oil, gas, and all other natural deposits must be based upon the actual cost of the properties containing such deposits. In no case shall the annual deduction on this account exceed 5 per cent of the gross value at the mine (well, etc.) of the output for the year for which the computation is made.
>
> ART. 142. The term "gross value at the mine," as used in paragraphs B and G of section 2 of the act of October 3, 1913, prescribing a limit to the amount which may be deducted in the return of individuals and corporations as depreciation in the case of mines, is held to mean the market value of ore, coal, crude oil, and gas at the mine or well, where such value is established by actual sales at the mine or well; and in case the market value of the product of the mine or well is established at some place other than at the mine or well, or on the basis of the bullion or metallic value of the ore, then the gross value at the mine is held to be the value of the ore, coal, oil, or gas sold, or of the metal produced, less transportation, reduction, and smelting charges.
>
> If the rate of 5 per cent per annum shall return to the corporation its capital investments prior to the exhaustion of the deposits, the rate on which the annual deduction for depletion of deposits is based must be lowered in accordance with the estimated number of years it will take to exhaust the estimated reserves.
>
> In case the reserves shall be in excess of the estimates, no further deduction on account of depletion shall be made where the

capital investment has been returned to the corporation.

The Revenue Act of September 8, 1916, c. 463, 39 Stat. 756, 759, 767, contains the following provisions in reference to deductions:

> SEC. 5. *Deductions allowed in computing net income of a citizen or resident of the United States.*
>
> * * * * *
>
> Seventh. A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade.
>
> Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided,* That when the allowances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the ex-

haustion thereof for which an allowance is or has been made.

SEC. 12. *Deductions allowed corporations, etc.*—(a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—

* * * * *

Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; (a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided,* That when the allowance authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made * * *.

○